westernZAGROS

*WesternZagros Resources Ltd.*

Second Quarter Interim Report
for the period ended June 30, 2008

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## MESSAGE TO SHAREHOLDERS

WesternZagros Resources Ltd. (TSX-V – WZR) ("WesternZagros") is pleased to provide its results for the three month period ended June 30, 2008 and key highlights to date.

- WesternZagros spudded its initial well, Sarqala-1, on May 8, 2008 and drilling operations continue to proceed.
- On June 23, 2008, WesternZagros announced that the Kurdistan Regional Government ("KRG") nominated a wholly-owned subsidiary of Talisman Energy Inc. ("Talisman") as the Third Party Participant in the Kalar-Bawanoor block. With this election, the working interests' of the Contractor Group are as follows: WesternZagros (operator) – 40%. Talisman – 40% and the KRG – 20%. With their election, Talisman paid WesternZagros $50.7 million under the terms of the Production Sharing Contract ("PSC") and Talisman funds its share of costs going forward.
- WesternZagros completed its seismic program in mid-July 2008 and has acquired a total of 1,547 kilometres of data under its Phase I and II program.
- May 2008 marked a full year of in-country operations with no Lost Time Incidents (LTI) and a combined total of 1.8 million exposure hours. This is a very significant achievement for WesternZagros and demonstrates the commitment of the Company's employees and contractors to the safety and security of WesternZagros' activities.
- For the three month period ended June 30, 2008, WesternZagros incurred capital expenditures of $28.6 million in association with its Phase II seismic program, the 2008 drilling program and certain payments required under the PSC and $55.2 million for the six month period ended June 30, 2008.
- WesternZagros had a net loss of $0.6 million, mainly comprised of the general and administrative costs incurred by the Company.
- As at June 30, 2008, WesternZagros had $180.8 million in cash and cash equivalents. These balances will be used to fund future exploration activities and the $9.9 million of accounts payable and accrued liabilities owing at June 30, 2008. With the election of Talisman into the Kalar-Bawanoor block, WesternZagros now funds 60 per cent of costs going forward.

- WesternZagros is pleased to announce that Mr. Ian Ross has joined the Company as Deputy General Manager, Kurdistan. Mr. Ross brings with him a depth of expertise in petroleum engineering including drilling, well testing and completions, early production systems, reservoir engineering, production operations, field development projects, health, safety, environment and security and business management. Most recently, Mr. Ross held the position of General Manager, Drilling with Premier Oil India BV. He was also Operations Manager for OMV (Iran) and worked with LASMO companies in Indonesia.
- In support of its commitment to give back to the communities in which the Company operates, WesternZagros has drilled five water wells and plans to drill an additional five wells before year-end in the Garmian region in Kurdistan. In addition, WesternZagros is completing a needs assessment within its PSC area which will provide the framework for the Company's initiatives in 2009. To date, identified areas of priority include water management, education and health care.

### REGIONAL ACTIVITY

The KRG and Baghdad held discussions in June 2008 regarding the hydrocarbon law and other key issues. Discussions between the KRG and the federal officials are ongoing; however, following this latest round of talks, a committee was formed to look at how to gain resolution of the federal oil and gas law. The committee, including some of Iraq's senior political figures, will study the framework for a hydrocarbons law. Prime Minister Barzani of the KRG and Federal Iraqi Prime Minister Nouri Al-Maliki are both on the committee and agreed to try and find a solution that will be in the interests of all Iraq.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

**For the Period Ended June 30, 2008** *(Amounts in United States Dollars unless otherwise indicated)*

Management's discussion and analysis ("MD&A") of WesternZagros Resources Ltd.'s ("WesternZagros" or the "Company") financial condition and results of operations should be read in conjunction with the unaudited Balance Sheet as at June 30, 2008 and the audited Balance Sheet as at December 31, 2007 and related notes prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The effective date of this MD&A is August 7, 2008.

WesternZagros was incorporated on August 22, 2007 under the laws of the Province of Alberta. On October 18, 2007, WesternZagros, Western Oil Sands Inc. (now Marathon Oil Canada Corporation) ("Western"), Marathon Oil Corporation, 1339971 Alberta Ltd. and WesternZagros Resources Inc. ("WZRI") completed a Plan of Arrangement (the "Arrangement"). In connection with the Arrangement, through a series of transactions, WesternZagros acquired all of the outstanding shares of WZRI. As the shareholders of Western Oil Sands Inc. ultimately continued to hold their respective interests in WZRI, there was no resulting change of control. Therefore, the acquisition was accounted for assuming continuity of business for WZRI under Emerging Issues Committee 89 – Exchanges of ownership interests between enterprises under common control – wholly and partially owned subsidiaries ("EIC-89). Consequently, under EIC-89 no fair value adjustments were made.

The consolidated financial statements of WesternZagros, and the disclosures found throughout the MD&A, reflect the assets and liabilities of WZRI at their book value as reported in the consolidated financial statements of WZRI. The continuity of business accounting requires that the results of operations presented in the consolidated financial statements of WesternZagros include the operations of WZRI for the entire fiscal period in which the Arrangement took place. In addition, the comparative consolidated financial statements of WesternZagros were restated to reflect the financial position and results of operations as if WesternZagros and WZRI had been combined since their inception. As a result, references to WesternZagros in the MD&A incorporate the activities of WZRI and its subsidiaries from their inception.

Additional information relating to WesternZagros is available on SEDAR at www.sedar.com.

### FORWARD LOOKING INFORMATION

This report contains certain forward-looking statements relating, but not limited, to the Company's operations, anticipated financial performance, business prospects and strategies. Forward-looking information typically contains statements with words such as "anticipate", "estimate", "expect", "potential", "could", or similar words suggesting future outcomes. We caution readers and prospective investors of the Company's securities to not place undue reliance on forward-looking information as by its nature, it is based on current expectations regarding future events that involve a number of assumptions, inherent risks and uncertainties, which could cause actual results to differ materially from those anticipated by WesternZagros. WesternZagros' operations are subject to all risks normally incidental to the exploration, development and operation of crude oil and natural gas properties and the drilling of crude oil and natural gas wells, including those risks described in the Risk Factors section of this Company's MD&A.

### OVERVIEW

WesternZagros is a publicly-traded Calgary-based, international natural resources company engaged in acquiring properties and exploring for, developing and producing crude oil and natural gas in Iraq. WesternZagros, through its wholly-owned subsidiaries, holds an interest in a Production Sharing Contract ("PSC") with the Kurdistan Regional Government ("KRG") in the Kurdistan Region of Iraq.

## OPERATIONS

WesternZagros is currently exploring for crude oil and natural gas in the Kurdistan Region of Iraq and has no current reserves or production. The Company's revenue is comprised entirely of interest earned on cash and cash equivalent balances.

WesternZagros spudded its first well at Sarqala-1 in Kurdistan on May 8, 2008 and drilling operations continue to proceed. Sarqala-1 is the first well of a multi-well drilling exploration program planned over the first exploration sub-period which ends on December 31, 2010.

WesternZagros continued to actively acquire seismic under its Phase II program and expanded its program to allow for seismic coverage across the entire PSC block. In July 2008, WesternZagros completed its Phase II seismic program and acquired a total of 1,547 kilometres under its Phase I and Phase II seismic programs. With the completion of the seismic program, interpretation of the data is underway in order to develop a list of drillable prospects by year end.

As the Company conducts its operations in Kurdistan, health, safety, environment and security are of utmost importance. As such, WesternZagros has adopted relevant Canadian guidelines where appropriate, including those established by the Alberta Energy Resources Conservation Board. Since 2004, WesternZagros has operated in Kurdistan without any serious safety or security incidents, and May 2008 marked a full year with no Lost Time Incidents (LTIs) and a combined total of 1.8 million exposure hours. This is a very significant achievement for WesternZagros and it demonstrates the commitment of the Company's employees and contractors to the safety and security of WesternZagros' operations.

## CHARGES UNDER SERVICE AGREEMENT

For the second quarter of 2008, WesternZagros did not incur any charges under a service agreement compared to $2.9 million for the prior year period. The charges incurred during 2007 related to operational, technical and other support expenditures incurred pursuant to a services agreement WZRI had with Western. Under the agreement, Western paid for various PSC negotiation costs, capital, operational, technical, legal, general and administrative expenditures on behalf of WZRI. These transactions were measured at the amount of consideration established and agreed to by the related parties. These transactions were undertaken with the same terms and conditions as transactions with non-related parties. This services agreement was terminated upon completion of the Arrangement on October 18, 2007.

## GENERAL AND ADMINISTRATIVE EXPENSES (G&A)

In the second quarter of 2008, WesternZagros incurred $1.5 million in general and administrative expenses compared to $1.9 million in the first quarter of 2008 and nil in the second quarter of 2007, when these costs were incurred under the service agreement with Western. The year-over-year increase is the result of increased activity and associated staff and consulting costs as WesternZagros continued to build the necessary infrastructure to support its expanding operations. Compared to the first quarter of 2008, general and administrative expenses were marginally lower.

### DEPRECIATION, DEPLETION AND AMORTIZATION (DD&A)

In the second quarter of 2008, WesternZagros recognized $0.06 million of DD&A related to certain administrative assets compared to $0.001 million for the prior year period and unchanged from the first quarter of 2008. No depletion was recorded because WesternZagros has yet to determine whether proved reserves are attributable to the PSC lands.

### FOREIGN EXCHANGE

WesternZagros adopted the US dollar as its measurement and reporting currency since the majority of its expenses are or will be directly or indirectly denominated in U.S. dollars and to facilitate a more direct comparison to other international crude oil and natural gas exploration and development companies. The Company has certain assets and liabilities in currencies other than the U.S. dollar, mainly Canadian dollars, and converts these to U.S. dollars at the end of each period resulting in foreign exchange gains and losses. During the second quarter of 2008, WesternZagros recorded a foreign exchange gain of $0.2 million compared to a loss of $0.7 million in the second quarter of 2007 and a loss of $0.7 million in the first quarter of 2008.

### NET LOSS

In the second quarter of 2008, WesternZagros had a net loss of $0.6 million compared to net loss of $1.8 million in the first quarter of 2008 and a net loss of $3.7 million in the second quarter of 2007. WesternZagros is an early stage exploration enterprise and, apart from its working interest in the PSC and cash and cash equivalents, the Company has no other assets.

### CAPITAL EXPENDITURES

For the six month period ended June 30, 2008, WesternZagros' capital expenditures totalled $55.2 million, and include the costs associated with the drilling of Sarqala-1, the procurement of tangible materials, equipment and services for the 2008 drilling program, the acquisition of seismic data under the Phase II seismic program and the required payments under the PSC to the KRG.

In the second quarter of 2008, WesternZagros' capital expenditures totalled $28.6 million compared to $26.6 million in the first quarter of 2008 and $6.9 million during the second quarter of 2007. The increase from the first quarter of 2008 is the result of increased activities and costs related to drilling as the Company commenced drilling activities at Sarqala-1 on May 8, 2008. The year-over-year increase is the result of increased activity including the commencement of drilling of Sarqala-1, the procurement of tangible materials, equipment and services for the 2008 drilling program, the acquisition of seismic under the Company's Phase II seismic program and the required payments under the PSC to the KRG.

WesternZagros capitalized $0.7 million in G&A costs directly related to exploration activities in the second quarter of 2008.

#### CONTRACT OBLIGATIONS AND COMMITMENTS

Under the terms of its PSC, WesternZagros has a 40 per cent working interest and the KRG has a direct 20 per cent interest in the PSC which is carried by WesternZagros. The remaining 40 per cent was allocated to a wholly-owned subsidiary of Talisman Energy Inc. ("Talisman") by the KRG as announced on June 23, 2008. Under the terms of the PSC, Talisman paid WesternZagros $50.7 million in costs incurred by the Company and Talisman will fund its share of costs going forward.

The PSC contemplates two exploration sub-periods of three years and two years, respectively, with two possible one-year extensions. The first exploration sub-period ends December 31, 2010. During such time the Contractor Group (WesternZagros, Talisman and the KRG) is required to complete a minimum of 1,150 kilometres of seismic surveying which the Company has already met and exceeded, drill three exploration wells and commit a minimum of $75 million in the aggregate on seismic, geologic studies and drilling. At the end of the first exploration sub-period, WesternZagros and the other parties to the PSC may relinquish the entire contract area (other than any discovery or development areas), or continue further exploration operations during the second exploration sub-period which ends December 31, 2012.

The PSC also includes capacity building support, payable by WesternZagros over a 15 month period and funding for certain technological, logistical, recruitment and training during the first exploration sub-period, and any subsequent sub-periods. WesternZagros estimates its 40 per cent share of the PSC work commitment for the first exploration sub-period, its previously paid signature bonus, the capacity building support and the requirement for the Company to carry the KRG's interest through the work commitment to be approximately $103 million.

During the second exploration sub-period, the Contractor Group, or those parties that have elected to participate in further exploration, is required to complete a minimum of 575 kilometres of seismic surveying, drill at least two exploration wells and commit a minimum of $35 million. At the end of the second exploration sub-period, WesternZagros, and the other parties to the PSC who have elected to participate in the second exploration, may relinquish the entire contract area (other than any discovery or development areas) or continue further exploration operations during two one-year extension periods, which would extend the total exploration period to December 31, 2014. At the end of the second exploration sub-period, and at the end of each subsequent extension period, the PSC requires WesternZagros, and other parties who have elected to participate, to relinquish 25 per cent of the remaining undeveloped area within the PSC lands or the entire contract area (other than any discovery or development areas).

WesternZagros has entered into various exploration related contracts, including contracts for drilling equipment, services and tangibles, and seismic surveying equipment and services, to meet the requirements under the PSC. The following table summarizes WesternZagros' commitments under these exploration related contracts and other contractual obligations.

| | Six months | For the year ended December 31 | | | | |
|---|---|---|---|---|---|---|
| *($ thousands)* | **2008** | 2009 | 2010 | 2011 | 2012+ | Total |
| Exploration | **8,687** | – | – | – | – | 8,687 |
| Office | **188** | 375 | 94 | – | – | 657 |
| Total | **8,875** | 375 | 94 | – | – | 9,344 |

## OUTLOOK

With the election of Talisman into the Kalar-Bawanoor block, WesternZagros now funds 60 per cent of costs going forward. As such, WesternZagros anticipates that its capital and operating budget will be approximately $25 million for the remainder of 2008. This excludes the capacity building support and other payments associated with the PSC signed in February 2008. Approximately 70 per cent of this budget is allocated to the remainder of the Company's Phase II seismic program and drilling activity in the Kurdistan Region.

WesternZagros' operational activities for the remainder of 2008 will focus on the drilling and completion of Sarqala-1, site construction and the commencement of drilling operations of the Company's next well at Kurdamir-1 (formerly North Bawanoor), and the processing and interpretation of the seismic data in order to compile an inventory of drillable prospects.

## LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2008, WesternZagros had $180.8 million in cash and cash equivalents. These balances will be used to fund future capital expenditures including: the work commitments with respect to the first exploration sub-period under the PSC, the requirement for WesternZagros to fund the KRG's 20 per cent interest; certain payments required under the amended PSC, including the capacity building payments; G&A expenditures; and, working capital requirements.

The election of Talisman as the third party participant by the KRG reduces the Company's funding requirements under the PSC to 60 per cent, and allows WesternZagros to carry on a multi-well exploration program with its existing financial resources through the first exploration sub-period ending December 31, 2010, exceeding the commitments under the PSC.

With any successful exploration wells, WesternZagros will require further financial resources to complete an appraisal program, and ultimately, if warranted, any development program. WesternZagros will continue to monitor and assess its financing requirements as the Company's exploration activities progress.

## OUTSTANDING SHARE DATA

As at June 30, 2008, there were 207,464,320 shares issued and outstanding. The number of common shares reserved for issuance pursuant to options granted will not exceed 10 per cent of the issued and outstanding common shares. In the second quarter of 2008, 750,000 stock options were granted to employees bringing the total stock options outstanding as of June 30, 2008 to 7,705,000.

## SUPPLEMENTAL QUARTERLY INFORMATION

The following table summarizes the key financial information on a quarterly basis for the periods indicated.

| *($ thousands, unless otherwise indicated)* | June 30 2008 | March 31 2008 | Dec. 31 2007 | Sept. 30 2007 |
|---|---|---|---|---|
| Revenues | 774 | 823 | 817 | – |
| Net Loss | 633 | 1,830 | 836 | 3,667 |
| Net Loss per Share *(US$/share)* | | | | |
| (Basic and Fully Diluted) | 0.01 | 0.01 | 0.01 | 0.02 |
| Capital Expenditures | 28,597 | 26,584 | 10,493 | 11,428 |
| Total Assets | 241,692 | 251,068 | 160,777 | 45,943 |
| Total Long-term Liabilities | 66 | – | – | 52,297 |
| Dividend *(US$ per Share)* | Nil | Nil | Nil | Nil |

| | June 30 2007 | March 31 2007 | Dec. 31 2006 | Sept. 30 2006 |
|---|---|---|---|---|
| Revenues | – | – | – | – |
| Net Loss | 3,677 | 2,246 | 1,718 | 2,063 |
| Net Loss per Share *(US$/share)* | | | | |
| (Basic and Fully Diluted) | 0.02 | 0.01 | 0.01 | 0.01 |
| Capital Expenditures | 6,870 | 5,765 | 12,783 | – |
| Total Assets | 36,104 | 27,236 | 21,499 | 8,707 |
| Total Long-term Liabilities | 39,084 | 27,994 | 20,214 | 16,645 |
| Dividend *(US$ per share)* | Nil | Nil | Nil | Nil |

## RISK FACTORS

An investment in WesternZagros should be considered highly speculative due to the nature of its activities and the present stage of its development. WesternZagros' risk factors include, but are not limited to, all the risks normally incidental to the exploration, development and operation of crude oil and natural gas properties and the drilling of crude oil and natural gas wells, including geological risk, encountering unexpected formations or pressures, potential environment damage, blow-outs, fires and spills, all of which could result in personal injuries, loss of life and damage to property of WesternZagros and others; premature declines of reservoirs; environment risks; delay or changes in plans with respect to exploration or development projects or capital expenditures; the ability to attract key personnel; the risk of commodity price and foreign exchange rate fluctuations.

All of WesternZagros' assets are located in the Kurdistan Region of Iraq. As such, WesternZagros is subject to political, economic, and other uncertainties, including, but not limited to, the uncertainty of negotiating with foreign governments, expropriation of property without fair compensation, adverse determinations or rulings by governmental authorities, changes in energy policies or the personnel administering them, nationalization, currency fluctuations and devaluations, disputes between various levels of authorities, arbitrating and enforcing claims against entities that may claim sovereignty, authorities claiming jurisdiction, potential implementation of exchange controls, royalty and government take increases and other risks arising out of foreign governmental sovereignty over the areas in which WesternZagros' operations are conducted, as well as risks of loss due to civil strife, acts of war, guerrilla activities and insurrections. WesternZagros' operations may be adversely affected by changes in government policies and legislation or social instability and other factors which are not within the control of WesternZagros including, among other things, adverse legislation in Iraq and/or the Kurdistan Region, a change in crude oil or natural gas pricing policy, the risks of war, terrorism, abduction, expropriation, nationalization, renegotiation or nullification of existing concessions and contracts, taxation policies, economic sanctions, the imposition of specific drilling obligations and the development and abandonment of fields.

For a complete list of risk factors please refer to Company's Annual Information Form which is available at www.westernzagros.com or on SEDAR at www.sedar.com.

## CHANGES IN ACCOUNTING POLICY

WesternZagros adopted the following new accounting standards effective January 1, 2008:

- Handbook Section 1400, General Standards of Financial Statements ("Section 1400");
- Handbook Section 1535, Capital Disclosures ("Section 1535");
- Handbook Section 3031, Inventories ("Section 3031");
- Handbook Section 3862, Financial Instruments – Disclosures ("Section 3862"); and
- Handbook Section 3863, Financial Instruments – Presentation ("Section 3863").

Section 1400 has been revised to include specific requirements for assessing and disclosing an entity's ability to continue as a going concern.

Section 1535 specifies the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance.

Section 3031 eliminates the use of a LIFO (last-in-first-out) based valuation approach for inventory. The standard also requires any impairment to net realizable value of inventory to be written down at each reporting period, with subsequent reversals when applicable. This standard can be applied prospectively with an initial adjustment to retained earnings or applied retrospectively with restatement of comparative balances. The adoption of this standard did not impact the Company's net loss or financial position.

Sections 3862 and 3863 replaced Handbook Section 3861, Financial Instruments – Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections placed increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The adoption of this standard did not impact the Company's net loss or financial position.

## CONSOLIDATED BALANCE SHEETS

| *(United States $ thousands) ("Unaudited")* | **June 30 2008** | December 31 2007 |
|---|---|---|
| **Assets** | | |
| Current Assets | | |
| Cash and Cash Equivalents | **180,817** | 100,367 |
| Accounts Receivable | **1,037** | 255 |
| Prepaid Expenses | **140** | 111 |
| | **181,994** | 100,733 |
| Long-term Assets | | |
| Property, Plant and Equipment *(note 5)* | **59,698** | 55,896 |
| Deposits Held in Trust *(note 6)* | **–** | 4,148 |
| | **59,698** | 60,044 |
| | **241,692** | 160,777 |
| **Liabilities** | | |
| Current Liabilities | | |
| Accounts Payable and Accrued Liabilities | **9,878** | 4,938 |
| Long-term Liabilities | | |
| Asset Retirement Obligation *(note 7)* | **66** | – |
| | **9,944** | 4,938 |
| **Shareholders' Equity** | | |
| Share Capital *(note 8)* | **253,635** | 175,405 |
| Warrants *(note 9)* | **–** | 4,570 |
| Contributed Surplus *(note 11)* | **4,712** | – |
| Deficit | **(26,599)** | (24,136) |
| | **231,748** | 155,839 |
| | **241,692** | 160,777 |

Commitments and Contingencies *(note 14)*

*See Accompanying Notes to the Consolidated Financial Statements*

Approved by the Board of Directors

Fred J. Dyment, Director

Randall Oliphant, Director

## CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT

| *(United States $ thousands, except per share amounts)* *("Unaudited")* | For the Three Month Period Ended June 30 | | For the Six Month Period Ended June 30 | |
|---|---|---|---|---|
| | **2008** | 2007 | **2008** | 2007 |
| **Revenues** | | | | |
| Interest Income | **774** | – | **1,597** | – |
| **Expenses** | | | | |
| Charges Under Service Agreement | **–** | 2,935 | **–** | 5,114 |
| General and Administrative | **1,546** | – | **3,420** | – |
| Depreciation | **60** | 1 | **120** | 3 |
| Foreign Exchange (Gain) Loss | **(199)** | 741 | **520** | 806 |
| | **1,407** | 3,677 | **4,060** | 5,923 |
| **Net Loss and Other Comprehensive Loss** | **633** | 3,677 | **2,463** | 5,923 |
| Deficit at Beginning of Period | **25,966** | 11,907 | **24,136** | 9,661 |
| **Deficit at End of Period** | **26,599** | 15,584 | **26,599** | 15,584 |
| **Net Loss Per Share** | | | | |
| **– Basic and Diluted** *(note 12)* | **0.01** | 0.02 | **0.01** | 0.03 |

*See Accompanying Notes to the Consolidated Financial Statements*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| *(United States $ thousands) ("Unaudited")* | For the Three Month Period Ended June 30 **2008** | 2007 | For the Six Month Period Ended June 30 **2008** | 2007 |
|---|---|---|---|---|
| **Cash Provided By (Used In)** | | | | |
| **Cash From Operating Activities** | | | | |
| Net Loss | **(633)** | (3,677) | **(2,463)** | (5,923) |
| Non-cash Items | | | | |
| Depreciation | **60** | 1 | **120** | 3 |
| Stock-based Compensation *(note 10)* | **266** | – | **589** | – |
| | **(307)** | (3,676) | **(1,754)** | (5,920) |
| Increase in Non-Cash Working Capital *(note 13)* | **137** | – | **(217)** | – |
| | **(170)** | (3,676) | **(1,971)** | (5,920) |
| **Cash From Financing Activities** | | | | |
| Share Issuance Under Private Placement *(note 8)* | **–** | – | **71,436** | – |
| Exercise of Warrants *(notes 8, 9)* | **–** | – | **6,048** | – |
| Increase in Due to Related Party | **–** | 11,089 | **–** | 18,869 |
| | **–** | 11,089 | **77,484** | 18,869 |
| **Cash From Investing Activities** | | | | |
| Capital Expenditures | **(27,648)** | (6,870) | **(54,232)** | (12,635) |
| Proceeds from Third Party Participant *(note 5)* | **50,675** | – | **50,675** | – |
| Deposits Held in Trust | **10,228** | – | **4,148** | – |
| Decrease in Non-cash Working Capital *(note 13)* | **(10,021)** | (460) | **4,346** | (242) |
| | **23,234** | (7,330) | **4,937** | (12,877) |
| **Increase in Cash and Cash Equivalents** | **23,064** | 83 | **80,450** | 72 |
| Cash and Cash Equivalents at Beginning of Period | **157,753** | 92 | **100,367** | 103 |
| **Cash and Cash Equivalents at End of Period** | **180,817** | 175 | **180,817** | 175 |

*See Accompanying Notes to the Consolidated Financial Statements*

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

*(Tabular amounts in United States $ thousands) ("Unaudited")*

### 1. NATURE OF OPERATIONS

WesternZagros Resources Ltd. (the "Corporation") was incorporated on August 22, 2007 under the laws of the Province of Alberta. On October 18, 2007, the Corporation, Western Oil Sands Inc. (now Marathon Oil Canada Corporation) ("Western"), Marathon Oil Corporation, 1339971 Alberta Ltd. and WesternZagros Resources Inc. ("WZRI") completed a Plan of Arrangement (the "Arrangement"). In connection with the Arrangement, the Corporation, through a series of transactions, acquired all of the outstanding shares in WZRI. Further information on the Arrangement can be found in note 4.

The Corporation is engaged in acquiring properties and exploring for crude oil and natural gas and is in the developmental stage. Through its subsidiaries, the Corporation holds an interest in a Production Sharing Contract ("PSC") with the Kurdistan Regional Government ("KRG") in respect of an exploration project area in the Kurdistan Region of Iraq.

### 2. SIGNIFICANT ACCOUNTING POLICIES

The interim consolidated financial statements are presented in accordance with Canadian Generally Accepted Accounting Principles. The interim consolidated financial statements have been prepared using the same accounting policies and methods of computation as the audited consolidated financial statements for the year ended December 31, 2007, except as described in Note 3. The disclosures provided below are incremental to those included in the annual consolidated financial statements. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto in the Corporation's annual report for the year ended December 31, 2007.

### 3. CHANGES IN ACCOUNTING POLICIES AND FUTURE ACCOUNTING POLICY CHANGES

a) **Capital Disclosures** On January 1, 2008, the Corporation adopted the CICA Handbook sections 1535 "Capital Disclosures". The adoption of this standard requires specific disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance.

b) **Inventories** On January 1, 2008, the Corporation adopted CICA Handbook Section 3031, "Inventories", which eliminates the use of a LIFO (last-in-first-out) based valuation approach for inventory. As the Corporation does not hold any inventory at this time, the adoption of this standard did not have an impact on the Corporation's net loss or financial position.

c) **Financial Instruments – Disclosure and Presentation** On January 1, 2008, the Corporation adopted CICA Handbook Section 3862 "Financial Instruments – Disclosures" and CICA Handbook Section 3863 "Financial Instruments – Presentation". The adoption of these standards increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks.

d) **Goodwill and Intangible Assets** As of January 1, 2009, WesternZagros will be required to adopt the CICA Handbook Section 3064, "Goodwill and Intangible Assets", which will replace the existing Goodwill and Intangible Assets standard. The new standard revises the requirement for recognition, measurement, presentation and disclosure of intangible assets. The adoption of this standard should not have a material impact on WesternZagros' Consolidated Financial Statements.

e) **International Financial Reporting Standards ("IFRS")** In January 2006, the CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, in February 2008, the AcSB confirmed that International Financial Reporting Standards ("IFRS") will replace Canadian GAAP in 2011 for profit-oriented Canadian publicly accountable enterprises. As WesternZagros will be required to report its results in accordance with IFRS starting in 2011, the Corporation is currently assessing the impact of these new accounting standards on its financial statements.

## 4. PLAN OF ARRANGEMENT

On October 18, 2007, Western announced the completion of the Arrangement pursuant to which the Corporation, through a series of transactions, acquired all of the outstanding shares in WZRI.

Pursuant to the Arrangement, the shareholders of Western continued to hold their respective interests in the Corporation, resulting in no change of control. Therefore, the acquisition was accounted for assuming continuity of business for WZRI under Emerging Issues Committee 89 – Exchanges of ownership interests between enterprises under common control-wholly and partially-owned subsidiaries ("EIC-89"). Consequently, under EIC-89 no fair value adjustments were made.

The consolidated financial statements of the Corporation reflect the assets and liabilities of WZRI at their book value as reported in the consolidated financial statements of WZRI. The continuity of business accounting requires that the results of operations presented in the consolidated financial statements of the Corporation include the operations of WZRI for the entire fiscal period in which the Arrangement took place. In addition, the comparative consolidated financial statements of the Corporation were restated to reflect the financial position and results of operation as if the Corporation and WZRI had been combined since their inception. The shares of the Corporation issued under the Arrangement were valued at the carrying value of the net assets of WZRI, excluding the accumulated deficit, as at October 18, 2007.

## 5. PROPERTY, PLANT AND EQUIPMENT

| June 30, 2008 | Cost | Accum. DD&A* | Net |
|---|---|---|---|
| Kurdistan Region Exploration Project | **59,242** | **–** | **59,242** |
| Corporate | **616** | **(160)** | **456** |
| | **59,858** | **(160)** | **59,698** |

| December 31, 2007 | Cost | Accum. DD&A* | Net |
|---|---|---|---|
| Kurdistan Region Exploration Project | 55,320 | - | 55,320 |
| Corporate | 616 | (40) | 576 |
| | 55,936 | (40) | 55,896 |

* Accumulated Depreciation, Depletion and Amortization

On June 23, 2008, the Corporation announced that the KRG nominated a wholly-owned subsidiary of Talisman Energy Inc. ("Talisman") as the Third Party Participant in the PSC. Under the terms of the PSC, Talisman paid WesternZagros $50.7 million in costs incurred by the Corporation and Talisman will fund its share of costs going forward. These costs have been credited against the total cost pool previously recorded.

All costs included in the Kurdistan Region Exploration Project are excluded from depletion as they represent costs related to properties incurred in cost centres that are considered to be in the pre-production stage. Currently, there are no proved reserves. All costs, net of any associated revenues, have been capitalized. The Corporation capitalized $1.0 million of general and administrative costs and $0.3 million of stock-based compensation directly related to exploration activities for the six months ended June 30, 2008 (December 31, 2007 $ – nil).

### 6. DEPOSITS HELD IN TRUST

The Corporation had deposited in trust certain amounts to be utilized to fund certain exploration expenditures and amounts due under the PSC as described in note 14(a). The funds for exploration expenditures relate to the drilling contract and the purchase of long lead time tangible items for drilling operations. The deposits bear interest at prevailing market rates. As at June 30, 2008, there are no funds remaining on deposit in the trust accounts.

### 7. ASSET RETIREMENT OBLIGATION

The Corporation records the fair value of legal obligations associated with the retirement and reclamation of tangible long-lived assets when incurred. The asset retirement cost, equal to the estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long-lived asset. The estimation of these costs is based on engineering estimates using current costs and technology and in accordance industry practice. With the commencement of the drilling of Sarqala-1, the Corporation recognized a net $0.01 million liability. The total undiscounted amount of estimated cash flow required to settle the obligation is $0.9 million which is assumed to be paid in the year 2033 in the most likely case. The Corporation used a credit risk adjusted risk-free rate of 10 per cent and an inflation rate of 4 per cent to calculate the net present value of the future retirement obligation.

### 8. SHARE CAPITAL

**Authorized**

The Corporation is authorized to issue an unlimited number of ordinary and preferred shares. The common shares are without nominal or par value.

**Issued and Outstanding**

| | Number of Shares | Amount |
|---|---|---|
| **Common Shares** | | |
| Issued on Incorporation – August 22, 2007 | 1 | 1 |
| Repurchased – Plan of Arrangement | (1) | (1) |
| Issued – Plan of Arrangement | 165,057,183 | 157,932 |
| Issued – Under Private Placement *(note 4)* | 5,000,000 | 12,766 |
| Issued – Exercise of Warrants | 1,646,864 | 4,201 |
| Issued – Warrant Value Transferred on Exercise of Warrants *(note 9)* | – | 506 |
| Balance at December 31, 2007 | 171,704,047 | 175,405 |
| Issued – Exercise of Warrants | 2,426,939 | 6,048 |
| Issued – Warrant Value Transferred on Exercise of Warrants *(note 9)* | – | 746 |
| Issued – Under Private Placement | 33,333,334 | 75,645 |
| Share Issuance Costs | – | (4,209) |
| Balance at June 30, 2008 | 207,464,320 | 253,635 |

During the period January 1 to January 18, 2008, the Corporation received approximately $6.0 million in total proceeds from the exercise of 2.4 million warrants. This brought the total proceeds to $10.2 million from the exercise of 4.1 million warrants over the life of the warrants.

On March 7, 2008, the Corporation completed a private placement for 33.3 million common shares at a price of Cdn$2.25 per share, for gross proceeds of Cdn$75 million (net Cdn$71 million).

## 9. WARRANTS

Pursuant to the Arrangement, the Corporation issued 16,505,729 warrants on October 18, 2007. Each whole warrant was exercisable at a price of Cdn$2.50 and expired on January 18, 2008. On October 18, 2007, the issue date of the warrants, the Black-Scholes calculated fair value was Cdn$0.30 per warrant. The following table presents the reconciliation of warrants outstanding:

| | Number of Warrants | Amount |
|---|---|---|
| **Warrants** | | |
| Issued – Plan of Arrangement *(note 4)* | 16,505,729 | 5,076 |
| Exercised | (1,646,864) | (506) |
| Balance at December 31, 2007 | 14,858,865 | 4,570 |
| Warrant Value Transferred to Share Capital on Exercise of Warrants | (2,426,939) | (746) |
| Warrant Value Transferred to Contributed Surplus on Exercise of Warrants | 12,431,926 | (3,824) |
| Balance at June 30, 2008 | – | – |

The fair value originally recorded on the 12,431,926 warrants that expired on January 18, 2008 of $3.8 million has been reclassed to Contributed Surplus, as the warrants associated with this amount were not exercised.

## 10. STOCK OPTIONS AND STOCK-BASED COMPENSATION

On October 16, 2007, the shareholders of the Corporation approved a stock option plan for the Corporation. Under the stock option plan, the Board of Directors may grant options to directors, officers, other employees and other service providers. The aggregate number of shares that may be reserved for issuance pursuant to stock options may not exceed 10 per cent of the issued and outstanding common shares on a non-diluted basis of the Corporation at the time of granting. During the three month period ending June 30, 2008, the Corporation granted 750,000 options to employees at an average exercise price of $2.92 per share and no options were cancelled. As at June 30, 2008, 7,705,000 options remain outstanding.

The fair value of all options granted have been estimated at the grant date using the Black-Scholes option pricing model. The weighted average fair values of the options and the assumptions used in their determination are as follows:

| | Six Month Period Ended June 30, 2008 |
|---|---|
| Weighted Average Fair Value ($ Per Share) | 0.88 to 1.16 |
| Risk Free Interest Rate | 3.71 to 4.11% |
| Expected Life (In Years) | 2.75 to 3.0 |
| Expected Volatility | 55% |
| Dividend Per Share | – |

During the three month period ending June 30, 2008, the Corporation recognized $0.3 million in stock-based compensation in general and administrative expense.

## 11. CONTRIBUTED SURPLUS

The following table presents the reconciliation of Contributed Surplus:

| | Three Months Ended June 30, 2008 | Six Months Ended June 30, 2008 |
|---|---|---|
| Balance at Beginning of Period | 4,147 | – |
| Recognized on Expiry of Warrants *(note 9)* | – | 3,824 |
| Stock-based Compensation | 565 | 888 |
| Balance at June 30, 2008 | 4,712 | 4,712 |

### 12. LOSS PER SHARE

The Corporation has calculated basic loss per share for the three and six month periods ended June 30, 2008 and 2007 as if the shares issued under the Arrangement were issued effective January 1, 2007 and considering subsequent issuances after the completion of the Arrangement on October 18, 2007. The basic weighted average number of common shares outstanding calculated on this basis is 207,464,320 for June 30, 2008 and 165,057,183 for June 30, 2007. Due to a loss for the three and six month periods ended June 30, 2008 and 2007, no incremental shares were included in the diluted earnings per weighted average number because the effect would have been anti-dilutive.

### 13. CHANGES IN NON-CASH WORKING CAPITAL

| | Three Months Ended June 30, 2008 | Six Months Ended June 30, 2008 |
|---|---|---|
| **Operating Activities** | | |
| Accounts Receivable | 110 | (134) |
| Prepaid Expenses | 83 | (29) |
| Accounts Payable and Accrued Liabilities | (56) | (54) |
| | 137 | (217) |
| **Investing Activities** | | |
| Accounts Receivable | (703) | (648) |
| Accounts Payable and Accrued Liabilities | (9,318) | 4,994 |
| | (10,021) | 4,346 |

### 14. COMMITMENTS AND CONTINGENCIES

#### Commitments

a) *Production Sharing Contract ("PSC")* Under the terms of its PSC, the Corporation has a 40 per cent working and the KRG has a direct 20 per cent interest in the PSC which will be carried by the Corporation. The remaining 40 per cent was allocated to a wholly-owned subsidiary of Talisman by the KRG as announced on June 23, 2008. Under the terms of the PSC, Talisman paid the Corporation $50.7 million in costs incurred by the Corporation and Talisman will fund its share of costs going forward. The Corporation, the KRG and Talisman will be collectively the "Contractor Group" under the PSC.

The PSC contemplates two exploration sub-periods of three years and two years, respectively, with two possible one-year extensions. The first exploration sub-period ends December 31, 2010. During such time, the Contractor Group is required to complete a minimum of 1,150 kilometres of seismic surveying which the Corporation has already met and exceeded, drill three exploration wells and commit a minimum of $75 million in the aggregate on seismic, geologic studies and drilling. At the end of the first exploration sub-period, the Corporation and the other parties to the PSC may relinquish the entire contract area (other than any discovery or development areas), or continue further exploration operations during the second exploration sub-period which ends December 31, 2012.

The PSC also includes capacity building support, payable by the Corporation over a 15 month period and funding for certain technological, logistical, recruitment and training during the first exploration sub-period, and any subsequent sub-periods. The Corporation estimates its share of the PSC work commitment for the first exploration sub-period, including the previously paid signature bonus, the capacity building payments, the various funding requirements and the requirement for the Corporation to carry the KRG's interest through the work commitments, to be approximately $103 million.

During the second exploration sub-period, the Contractor Group, or those parties who have elected to participate in further exploration, is required to complete a minimum of 575 kilometres of seismic surveying, drill at least two exploration wells and commit a minimum of $35 million. At the end of the second exploration sub-period, the Corporation or those parties who have elected to participate in the second exploration sub-period, may relinquish the entire contract area (other than any discovery or development areas), or continue further exploration operations during two one-year extension periods, which would extend the total exploration period to December 31, 2014.

At the end of the second exploration sub-period, and at the end of each subsequent extension period, the PSC requires the Corporation, and those parties who have elected to participate, to relinquish 25 per cent of the remaining undeveloped area within the PSC lands.

The Corporation will be the operator of the PSC lands during the first exploration sub-period, and for subsequent sub-periods a joint operating company will be established between the Corporation, the KRG and Talisman, if so elected.

b) *Participation Rights* The Corporation has granted participation rights for up to five per cent in respect to the Corporation's interest in the PSC to certain third parties at the same terms as the Corporation has under the PSC. Certain portions of the participation interest may be funded by interest bearing loans granted by the Corporation.

b) *Other* The Corporation has entered into various exploration related contracts, including drilling equipment, services and tangibles, and seismic surveying equipment and services, to meet its requirements under the PSC. The following table summarizes the commitments the Corporation has under these exploration related contracts and other contractual obligations at June 30, 2008:

| | 6 months | For the Year Ending December 31, | | | | |
|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012+ | Total |
| Exploration | 8,687 | – | – | – | – | 8,687 |
| Office | 188 | 375 | 94 | – | – | 657 |
| | 8,875 | 375 | 94 | – | – | 9,344 |

**Contingencies**

*Regulatory* Oil and gas operations are subject to extensive controls and regulations imposed by various levels of government that may be amended from time to time. The Corporation's operations may require licenses and permits from various governmental authorities in the countries in which it operates. Under the PSC, the KRG is obligated to assist in obtaining all permits and licenses from any government agencies in the Kurdistan Region and from any other government administration in Iraq. There can be no assurance that the Corporation will be able to obtain all necessary licenses and permits that may be required to carry out exploration and development of its projects.

The political and security situation in Iraq is unsettled and volatile. The Kurdistan Region is the only "Region" of Iraq that is constitutionally established pursuant to the Iraq Constitution, which expressly recognizes the Kurdistan Region. The political issues of federalism and the autonomy of the Regions of Iraq are matters about which there are major differences between the various political factions in Iraq. These differences could adversely impact the Corporation's interest in the Kurdistan Region.

## 15. FINANCIAL INSTRUMENTS

Financial instruments of the Corporation consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities. The Corporation's cash and cash equivalents are designated as held-for-trading and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments. Accounts receivable are designated as loans and receivables and recorded at amortized cost, which approximates fair value due to the short term nature of the instrument. Accounts payable and accrued liabilities are designated as other liabilities and are recorded at cost. The fair value of accounts payable and accrued liabilities approximate their carrying values due to the short term nature of these instruments.

The Corporation is exposed to credit risk, market risk, liquidity and funding risk. The following is a description of those risks and how the Corporation manages exposure to them:

**Credit Risk** Credit risk is the risk of loss associated with a counterparty's inability to fulfill its payment obligations. The Corporation is currently exposed to credit risk on its cash and cash equivalents, to the extent that these balances are invested with various institutions. The Board of Directors of the Corporation has approved an Investment Policy to dictate the various types of instruments and institutions that can be invested in and monitors these against this policy on a regular basis. Currently, the Corporation has entered into transactions for cash equivalents with major Canadian financial institutions with investment grade credit ratings, as well as purchases Government of Canada instruments.

Under the terms of the PSC, as described in note 14 (a), the KRG elected a wholly-owned subsidiary of Talisman as the third party participant under the PSC. The Corporation is subject to credit risk associated with Talisman's 40 per cent interest in the PSC and its share of related expenditures. Penalty provisions are included under the PSC for amounts in default.

**Market Risk** Market risk is the risk of loss that may arise from changes in market factors such as interest rate, foreign exchange rates and equity or commodity prices. The Corporation is exposed to interest rate risk to the extent that changes in market interest rates will impact any interest earned on the Corporation's cash and cash equivalent and deposit held in trust balances. The Corporation is also exposed to foreign exchange risk, as the majority of costs are anticipated to be incurred in U.S. dollars and the funds it will have available to it may be in other currencies.

The Board of Directors of the Corporation has approved an Investment Policy to dictate the various types of instruments and institutions that can be invested in and monitors these against this policy on a regular basis. The Board of Directors has also approved a Foreign Exchange Policy to dictate the currencies held by the Corporation and the instruments that can be utilized by the Corporation to meet day to day needs. This Foreign Exchange Policy requires the Corporation to hold the majority of its cash and cash equivalents in U.S. dollars and the type and duration of instruments that can be used to meet the Corporation's day to day foreign exchange needs. Neither policy permits the Corporation to enter into any economic hedging as it relates to interest or foreign exchange risks.

**Liquidity and Funding Risks** Liquidity and funding risk is the risk that the Corporation may be unable to generate or obtain sufficient cash or its equivalent in a timely and cost-effective manner to meet our commitments as they come due. As the Corporation is engaged in acquiring properties and exploring for crude oil and natural gas and is in the developmental stage, it currently does not have a revenue source outside of interest on its cash and cash equivalent balances. The Corporation is therefore required to fund its share of all commitments from existing cash and cash equivalent balances or access additional sources of cash from the equity markets. The Board of Directors reviews the Corporation's cash and cash equivalent balances against the Corporation's commitments and assesses the timing and need for additional equity financing on a regular basis. However, the Corporation's results will impact its access to the capital necessary to meet these commitments. There can be no assurance that equity financing will be available or sufficient to meet these requirements or for other corporate purposes or, if equity financing is available, that it will be on terms acceptable to the Corporation. The inability of Corporation to access sufficient capital for its operations could have a material adverse effect on the Corporation's financial condition, results of operations and prospects.

### 16. CAPITAL STRUCTURE

The Corporation's objectives when managing its capital structure are to:

i) Ensure adequate level of available cash and cash equivalents to meet the Corporation's commitments under the PSC.

ii) To prudently fund expenditures related to the acquisition of properties, and for exploration, appraisal and development of crude oil and natural gas resources

The Corporation funds its share of expenditures of all commitments from existing cash and cash equivalent balances received primarily from issuances of shareholders equity. The Corporation is has not entered into any debt financing arrangements at the balance sheet date and is not subject to any externally imposed capital requirements.

The Board of Directors regularly reviews the Corporation's cash and cash equivalents against the Corporation's expenditure commitments and assesses the timing and need for additional equity financing. The Corporation's results will impact its access to the capital necessary to meet these expenditure commitments. There can be no assurance that equity financing will be available or sufficient to meet those requirements, or for other corporate purposes, or if equity financing is available, that it will be on terms acceptable to the Corporation. The inability of the Corporation to access sufficient capital for its operations could have a material adverse impact on the Corporation's financial condition, results of operations and prospects.

## CORPORATE INFORMATION

### OFFICERS

FRED DYMENT
*Executive Chairman*

M. SIMON HATFIELD
*President*

GREG STEVENSON
*Vice President, Finance*

ROBERT THERIAULT
*Senior Vice President,*
*Engineering and Operations*

CHARLES BERARD
*Corporate Secretary*

### DIRECTORS

DAVID BOONE
*Independent Businessman*
*Calgary, Alberta*

FRED DYMENT
*Executive Chairman*
*WesternZagros Resources Ltd.*
*Calgary, Alberta*

JOHN FRANGOS
*Independent Businessman*
*Calgary, Alberta*

SIMON HATFIELD
*President*
*WesternZagros Resources Ltd.*
*Calgary, Alberta*

JAMES HOUCK
*Independent Businessman*
*Calgary, Alberta*

RANDALL OLIPHANT
*Chairman and Chief Executive Officer*
*Rockcliff Group Limited*
*Toronto, Ontario*

WILLIAM WALLACE
*Independent Businessman*
*Glenwood Springs, Colorado*

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### LEGAL COUNSEL

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### TRANSFER AGENT AND REGISTRAR

VALIANT TRUST COMPANY
*Calgary, Alberta*

### STOCK EXCHANGE LISTING

TSX VENTURE EXCHANGE
*Common Shares: WZR*